

General Information Letter: Petition to use separate accounting is not needed if two corporations are not engaged in a unitary business.

October 27, 1998

Dear:

This is in response to your letter dated October 13, 1998, in which you request permission to use an alternative method of allocation or apportionment. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding against the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of Department policy that apply, interpret or prescribe the tax laws and are not binding against the Department. See 2 Ill. Adm. Code 100.1200(b) and (c) enclosed.

Although a ruling granting an alternative allocation or apportionment has been requested, since the petition fails to sustain the burden of proof required pursuant to 86 Ill. Adm. Code 100.3390 (copy enclosed) the Department must respond by a GIL denying the petition.

In your letter you have stated as follows:

I am hereby petitioning under IITA section 304 to use the separate accounting method as an alternative apportionment formula on the 1998 Form IL-1120-ST for COMPANY A. As shown by the following clear and cogent evidence, the statutory formula would result in the taxation of extraterritorial values and the statutory formula would operate unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of proportion to the business transacted in Illinois. Furthermore, in this case, the separate accounting method would fairly and accurately apportion income to Illinois based upon business activity in Illinois.

First, an overview of the entire corporate structure is in order. COMPANY A was incorporated in Illinois on x/xx/xx. It operates exclusively within Illinois. On x/xx/xx, it bought 100% of the stock of COMPANY B. COMPANY B operates exclusively in Wisconsin. COMPANY B continues to enjoy its complete autonomy. The two entities are not dependent upon each other in any way. They are absolutely not a unitary business. They are run independently of one another and function on a day-to-day basis as they did before the stock transaction.

After the stock transaction, the two corporations properly filed separate state income tax returns (COMPANY A in Illinois and COMPANY B in Wisconsin) and a consolidated federal income tax return. Now COMPANY A has elected S-corporation status and COMPANY B has become a qualified subsidiary. Therefore, COMPANY B has ceased to exist for federal income tax purposes and its required corporate dissolution has necessitated this petition.

Please find attached a pro-forma statutory apportionment for the previous year (1997). This is contrasted with the presentation of a separate accounting. Completely separate and distinct sets of books are meticulously kept to accurately distinguish between Illinois and Wisconsin activities. The corporations go to great expense and administrative effort to maintain these records. As the reader of this petition scrutinizes these materials, one will surely come to the erudite conclusion that a separate accounting more clearly reflects respective state activity. This undeniable fact will jump off the page at you.

The statutory method would have resulted in Illinois base income of \$106,906. The separate accounting method would have resulted in Illinois base income of \$50,245. If ever there was a case worthy of the granting of the Director's permission, this is it.

In conclusion, we respectfully request that you seriously consider this meritorious petition. The state of Wisconsin does not require a non-unitary filer to obtain permission to use the separate accounting method.

Ruling

For reasons more fully detailed below, your petition for an alternative allocation or apportionment is denied for failing to meet the required burden of proof as set forth by Illinois Income Tax Regulations section 100.3390(c).

The petition states that due to COMPANY A's newly elected Subchapter S status, separate accounting must be employed to fairly reflect COMPANY A's Illinois net income. Specifically, the petition explains that prior to its subchapter S election, COMPANY A and its wholly owned subsidiary, COMPANY B, filed separate income tax returns in Illinois and Wisconsin, respectively. Since the activities of COMPANY B in Wisconsin and those of COMPANY A in Illinois did not comprise a unitary business, it is stated that such separate filing was proper. Upon COMPANY A's election under Internal Revenue Code (IRC) section 1362, COMPANY B has become a qualified subchapter S subsidiary (QSSS). Under IRC section 1361(b)(3), the separate corporate existence of a QSSS is ignored for federal income tax purposes, and all assets, liabilities, and items of income, deduction, and credit are treated as those of the S corporation parent. Accordingly, the corporate existence of COMPANY B will be ignored and all of its assets, liabilities, and income items will be treated as owned by COMPANY A. Because the same treatment will apply for Illinois tax purposes, the petition assumes that the income of COMPANY B must now be apportioned by COMPANY A together with the income from its Illinois activities. It is stated that such an apportionment will unreasonably allocate to Illinois income derived in Wisconsin. To avoid that allocation, the petition requests that the separate accounting method be employed to more fairly divide COMPANY A's income between its Illinois activities and COMPANY B's activities in Wisconsin.

Illinois Income Tax Regulations 100.3010(b) states as follows:

Two or more businesses of a single person.

- 1) A person may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. In the case of a person other than a resident, the income of each business is then apportioned by a formula

which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.

Applying that regulation in this case, the constructive liquidation of COMPANY B for income tax purposes does not require that COMPANY A change its separate reporting of income between Illinois and Wisconsin. In other words, assuming that COMPANY A and COMPANY B are not engaged in a single unitary business, the activities in Wisconsin are not made unitary with the activities in Illinois merely because COMPANY B ceases to exist for income tax purposes. The Wisconsin operations will now be viewed simply as a separate trade or business of COMPANY A. Since the petition represents that none of that trade or business is conducted in Illinois, COMPANY A need not allocate to Illinois any part of the income derived by COMPANY B in Wisconsin. As was the case before its subchapter S election, COMPANY A need only allocate to Illinois the income derived from its Illinois activities.

In light of the above, petition for the alternative allocation or apportionment requested here would seem no longer necessary. Nonetheless, the merits of your petition have been considered below.

Where the activities of a taxpayer in Illinois form part of a unitary business that extends into other states, the Illinois Income Tax Act ("the IITA"; 35 ILCS 5/101 et seq.) requires that the income generated by those activities be apportioned under a three-factor formula.

The three-factor apportionment formula compares the person's Illinois and aggregate property, payroll, and sales (IITA §304(a)). Illinois rejects the separate or geographical accounting method in such circumstances since that method ignores or captures inadequately the many subtle and unquantifiable transfers of value that take place among the components of a single enterprise (Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 164-5, 103 S. Ct. 2933, 2940 (1983)). Thus, the formula apportionment method is used, which focuses upon certain objective measures of a taxpayer's activities within and without the state (*Id.*). At the same time, however, formula apportionment may not be applied without exception. The factors used in the apportionment formula must actually reflect, in each individual case, a reasonable sense of how income is generated (*Id.* at 2942). And where the apportionment formula does not so reflect, a fair and accurate alternative method is appropriate (86 Ill. Adm. Code 100.3390(c)). Accordingly, IITA section 304(f) allows the taxpayer to petition the Director for an alternative apportionment method, including separate accounting, where the statutory method does not fairly represent the extent of the person's business activity in Illinois.

Consistent with these principles, Illinois Income Tax Regulations section 100.3390(c) sets forth the taxpayer's burden under section 304(f) as follows:

A departure from the required apportionment method is allowed only where such methods do not accurately and fairly reflect business activity in Illinois. An alternative apportionment method may not be invoked ... merely because it reaches a different apportionment percentage than the required statutory formula. The party ... has the burden of going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in the state. In addition the party ... must go forward with the evidence and prove that the proposed

alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State.

In addition, Regulations section 100.3390(d) states:

A petition will be summarily rejected if its sole basis for support rests on the fact that an alternative method reaches a different apportionment percentage than the required statutory formula.

These sections of the Regulations indicate the taxpayer's burden under IITA section 304(f) to be two-fold. In particular, it must be shown not only that the alternative method proposed results in a fair allocation, but also that application of the statutory method results in an unfair allocation. Moreover, because separate accounting does not fully reflect the value-producing factors of a unitary business, the second aspect of the taxpayer's burden is not satisfied merely by showing that separate accounting results in an allocation that differs from the statutory method. Thus, a petition that rests solely on an allocation under the separate accounting method must be rejected since it does not reveal any defect or unfairness in applying the factors relied upon by the three-factor formula to approximate where the income of the business is generated.

In this case, the petition contains in support of an alternative allocation an apportionment under the separate accounting method that differs from the apportionment that results by application of the statutory three-factor formula. The petition argues that separate accounting provides the better approach in this case due to the constructive liquidation of COMPANY B under IRC section 1361(b)(3). However, as indicated above, that liquidation does not affect the substance of the taxpayer's business activities in either Illinois or Wisconsin. Accordingly, the petition's sole basis for support rests upon on the fact that the separate accounting method reaches a different result. As such, the petition must be denied in accordance with Illinois Regulations section 100.3390(d).

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you wish to obtain a PLR which will bind the Department, please submit a request conforming to the requirements of 2 Ill. Adm. Code 100.1200 and 86 Ill. Adm. Code 100.3390.

Sincerely,

Paul Caselton
Associate Chief Counsel - Income Tax